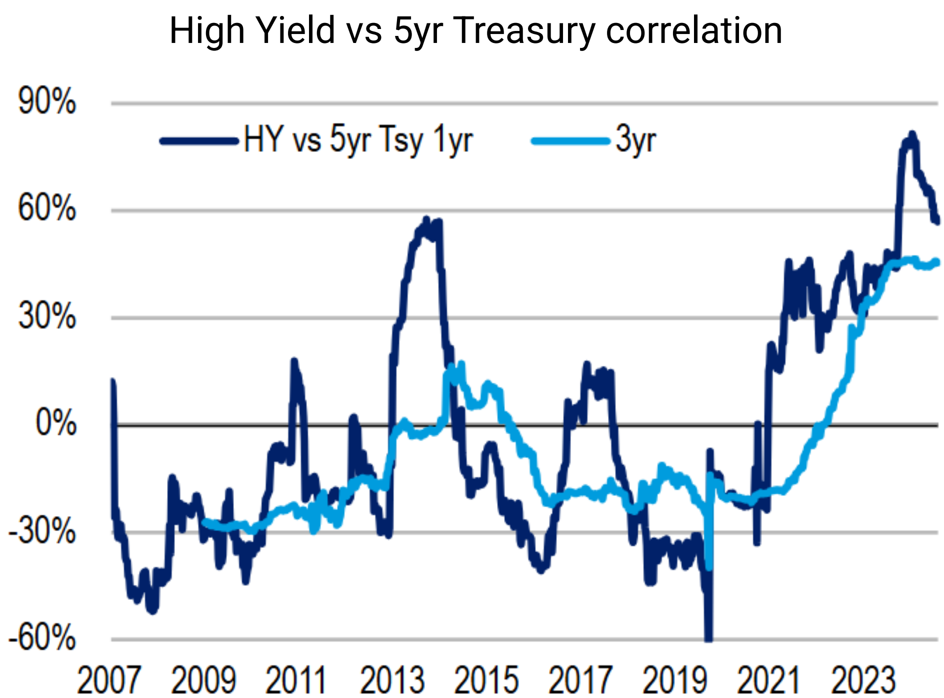
SMITH
CAPITAL INVESTORS

The Fed Still Matters… Even for High Yield

With interest rates and the Fed being top of mind for investors over the past 4 years, it's no surprise that fixed income markets are exhibiting historically high correlations to interest rates. That said, when we take a closer look at High Yield (HY) credit, the magnitude of the correlation, especially within a historical context, may surprise you.

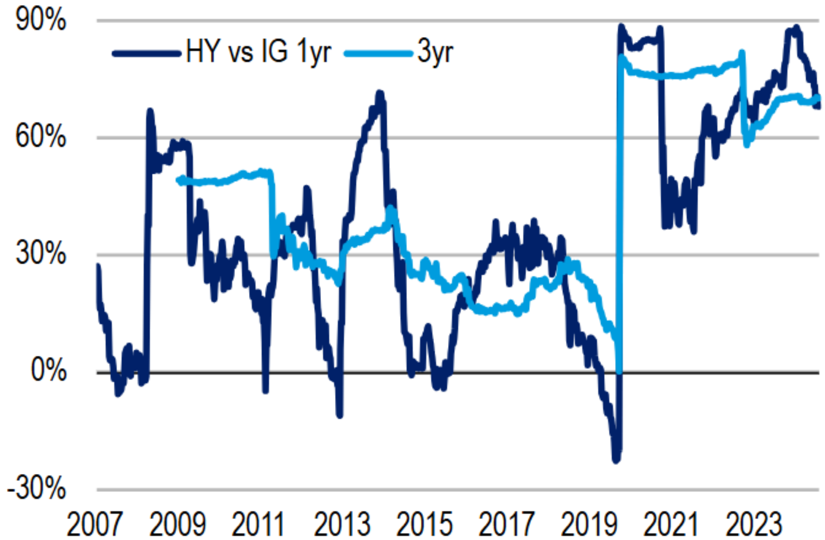
According to BofA Global Research, the trailing one-year correlation of the HY market (ICE BofA US High Yield Index) to five-year Treasury bonds stands around +60%. This figure, while down from the recent highs, sharply contrasts with the mostly negative correlation that existed from 2007 to 2020 and correlations in the +30-40% range from 2021 to 2023.



**Based on weekly total returns, trailing 1-year and 3-years*
Source: BofA Global Research (1/24/2025)

The increased sensitivity of HY to rates can also be seen in the correlation to the ICE BofA US Corporate (Investment Grade) Bond Index, with recent readings around +70% compared to historical levels (2007-2019) mostly ranging from 0% to +60%. The elevated correlation between HY and IG makes sense when put in the context of historically low spreads, with IG and HY spreads near 15-year lows and dispersion among rating categories, both within IG and HY, at historically low levels. Traditionally, given longer duration and lower spread, IG has been viewed as much more rate-sensitive than HY.

High Yield vs Investment Grade correlation

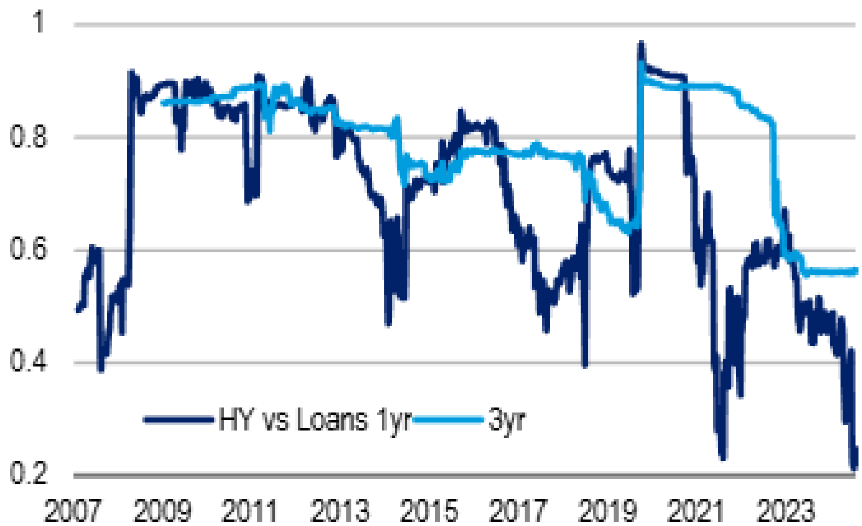


**Based on weekly total returns, trailing 1-year and 3-years*
Source: BofA Global Research (1/24/2025)

The elevated correlation of HY to rates is especially striking when put in the context of HY market option-adjusted duration (OAD) of 2.96, near all-time lows and compared to a 30-year average of 4.13. Duration could continue to move lower as coupons continue to reset toward market yields, with the current average coupon in the HY Index standing at 6.41%, 82 basis points (bps) lower than the Index yield-to-worst (YTW) of 7.23%.

As the correlation of HY to rates and IG has moved higher, the correlation to Leveraged Loans (LL) has gone in the opposite direction. This makes sense given the floating rate nature of LL coupons; however, this trend is also a reflection of the divergence in underlying fundamentals, a topic we have discussed repeatedly over the past few years. While the HY market has seen credit ratings upgrades outpacing downgrades on an annual basis since 2020, the loan market has seen net downgrades since 2021. This dynamic is also reflected in the widening gap between HY and LL default rates, with the gap (302bps as of 12/31/2024) at a high since 2000. Despite record repricing activity in the loan market (49% of the loan market repriced in 2024 with an average margin reduction of 55bps) and lower future interest burden providing a fundamental tailwind to LL credits, we do not expect the divergence in credit quality to reverse anytime soon.

High Yield vs Leveraged Loan correlation



**Based on weekly total returns, trailing 1-year and 3-years*
Source: BofA Global Research (1/24/2025)

Historically high-interest rate correlations in a historically low/negatively correlated asset class such as HY reinforces the idea that rates and yield curve will be key drivers of return for corporate credit this year. The nuance being that HY given the duration profile is likely skewed toward FOMC policy and the direction of front rates while IG, with longer duration, is likely more driven by rate moves further out on the yield curve. This increased rate sensitivity comes at a time when interest rate volatility remains elevated relative to the prior decade, increasing the challenge for fixed income investors looking to effectively position portfolios. While our credit process remains bottom-up focused with a macro-overlay, we are laser-focused on understanding and positioning around rates and yield curve given our view that these factors will continue to be primary drivers of outcomes across fixed income markets.

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Let’s keep talking!

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